

United States 7
Circuit Court of Appeals
For the Ninth Circuit

WILLIAM C. KOTTEMANN,
Petitioner,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of the Record

Upon Petition to Review an Order of the United States
Board of Tax Appeals

FILED

FEB - 4 1935

PAUL P. O'BRIEN,
Clerk

NO. 7727

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Circuit Court of Appeals
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italics; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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[1*]

Docket No. 45929

United States Board of Tax Appeals

WM. C. KOTTEMANN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

APPEARANCES

For Taxpayer: A. Calder Mackay, Esq., Arthur
McGregor, Esq.,

For Commissioner: T. M. Mather, Esq., E. M.
Woolf, Esq.

DOCKET ENTRIES

1929

Oct. 4—Petition received and filed. Taxpayer no-
tified. Fee paid.

” 5—Copy of petition served on General Coun-
sel.

Dec. 2—Answer filed by General Counsel.

” 4—Copy served on taxpayer. Circuit Cal-
endar.

*Page numbering appearing at the top of page of original certified
Transcript of Record.

1933

- July 11—Hearing set week beginning September 25, 1933, Long Beach, California.
- Oct. 5—Hearing had before Mr. Van Fossan, Division 9, on merits. Appearance of A. Calder Mackay and A. McGregor, Esqs. Amended petition in 45929 filed. Briefs due December 1, 1933. No exchange.
- ” 18—Transcript of hearing of October 5, 1933 filed.
- Nov. 23—Motion for extension to January 30, 1933 to file brief filed by taxpayer. November 25, 1933 Granted to December 15, 1933. Both parties.
- Dec. 14—Proposed findings of fact and brief filed by taxpayer.

1934

- Mar. 6—Memorandum opinion rendered—Mr. Van Fossan, Division 9. Decision will be entered under Rule 50.
- ” 28—Order correcting memorandum opinion entered.
- Apr. 3—Notice of settlement filed by General Counsel.
- ” 6—Hearing set April 25, 1934 on settlement.
- ” 25—Hearing had before Mr. Morris, Division 14, on settlement—Rule 50. Referred to Mr. Van Fossan.
- ” 27—Decision entered—Mr. Van Fossan, Division 9.

July 23—Petition for review by U. S. Circuit Court of Appeals, Ninth Circuit, with assignments of error filed by taxpayer.

” 23—Proof of service filed by taxpayer.

Sept. 18—Motion for extension to November 21, 1934 to complete record filed by taxpayer. Granted.

Nov. 19—Praecipe filed—proof of service thereon.

” 19—Order enlarging time to December 31, 1934 for transmission and delivery of record entered.

[2] [Endorsed]: Filed Oct. 4, 1929

Docket No. 45929

United States Board of Tax Appeals

WM. C. KOTTEMANN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above named taxpayer hereby appeals from the determination of the Commissioner of Internal Revenue set forth in his deficiency letter (IT:AR: B-10-HRK-60K) dated August 7, 1929, and as the basis of his appeal sets forth the following:—

JURISDICTION OF THE BOARD

1. The taxpayer is a resident of the State of California and is married.
2. The deficiency letter, a copy of which is attached, was mailed to the taxpayer on August 7, 1929, and discloses a deficiency in tax of \$2,878.63 for the year 1927.
3. The taxes in controversy are Income Taxes for the calendar year 1927 and the amount is less than \$10,000.00.

ASSIGNMENTS OF ERROR

4. The determination of tax contained in the said deficiency letter is based upon the following errors:

(a) The commissioner has erred in denying to the taxpayer the right to treat as a proper business expense and as a deduction from his gross income the amount of certain legal fees paid by him.

(b) The Commissioner has further erred in alleging that such legal expense was not a proper business deduction.

[3] (c) The Commissioner has further erred in disallowing the deduction of that legal expense by not taking into consideration all of the facts, circumstances and conditions directly or indirectly associated or connected with that expenditure for legal expense.

(d) The Commissioner has further erred in disallowing bad debts written off in the respective amounts of \$12,305.71 and \$1,015.65, which amounts the Commissioner has erroneously alleged were not uncollectible and were not bad debts although acknowledging that the debtors were in the hands of receivers.

(e) The Commissioner is further in error in alleging that such bad debts and/or no portion thereof was properly deductible by the taxpayer in 1927 due to the fact that the receivers of the debtor corporations proposed to pay the unsecured claims in stock; and the Commissioner is further in error in

denying the taxpayer the right to the deduction by holding that the stock to be received from the receivers will take the place of the indebtedness and will have the same value as the indebtedness incurred.

(f) The Commissioner has further erred in denying the taxpayer the deductions for bad debts and legal expense due to the fact that in equity to the taxpayer such deductions should be allowed during that year in order to more truly reflect the correct and proper taxable net income; and the Commissioner has further erred in disregarding the fact that there was an abnormal gross income reported by the taxpayer during that year, a substantial portion of which gross income was represented by the uncollectible accounts which the Commissioner now erroneously disallows.

[4] (g) Accordingly the Commissioner has erred in the calculation of the net income subject to tax and in the calculation of the tax liability and of the resulting deficiency in tax.

STATEMENT OF FACTS

(5) The facts upon which the taxpayer relies as the basis of his appeal are as follows:

(a) The taxpayer, Wm. C. Kottemann, is a citizen of the United States, residing in the State of California, and is engaged in the practice of public accounting and is licensed to practice as a Certified Public Accountant in the States of New York and California. He has been for a number of years

engaged in the practice of accounting in the State of California.

He has consistently filed correct, proper and true returns of taxable income on an accrual basis for a number of years.

A considerable part of the taxpayer's practice consists of investigations and audits made in the usual course of business by him and his organization at the request of, or upon the recommendation of, bankers, stockholders, attorneys, et cetera.

During the month of May, 1926, the taxpayer was requested to arrange a conference with certain officers of the Pacific-Southwest Trust & Savings Bank of Los Angeles relative to an investigation and audit which the officers of that bank desired the taxpayer to make.

Prior to that time there had been organized and there was in operation a corporation known as the Julian Petroleum Corporation, of which Mr. C. C. Julian was the President. Stock in that corporation had been sold to thousands and thousands of stockholders. [5] Several years subsequent to the organization of that corporation Mr. S. C. Lewis acquired the control of the Julian Petroleum Corporation from Mr. C. C. Julian.

Mr. S. C. Lewis proposed certain expansion, certain mergers and consolidations and other steps involving refinancing the company. His major financing was to be through the issuance of certain first mortgage bonds. It appears that there was some difficulty in carrying out the financial program due

principally to the unsatisfactory and rather hectic conditions in connection with the stock market trading in the Preferred and Common stocks of the Julian Petroleum Corporation. It was alleged by Mr. Lewis that he could remedy that situation and accordingly he and/or his associates acquired a stock brokerage business which had been in existence for a long time prior thereto. He acquired the business formerly conducted under the name of A. C. Wagy & Co. and incorporated a new company known as A. C. Wagy & Co., Inc.

At the conference held at the bank with Messrs. Motley H. Flint and I. L. Rouse, Vice-President of the Bank, various conditions and circumstances were explained to the taxpayer. They told the taxpayer that they desired an audit and investigation to be made of A. C. Wagy & Co., Inc., due to the fact that they were lending, or proposed to lend, money to that company and/or to S. C. Lewis. At that time the public had no knowledge of the acquisition of that brokerage house by S. C. Lewis. The taxpayer was informed that the bank, acting through its officers, had insisted in their negotiations with Mr. Lewis that the bank should be give the right to select an [6] auditor of their own choice who, however, was to report to the bank any and all of his findings although any such information was to be made available to Mr. Lewis so that he might derive the benefit therefrom.

The necessary audits and investigations were started. There were numerous errors and con-

sequently thousands of adjustments. The business of that brokerage house grew by leaps and bounds. The extent of its trading ran into considerable sums. It rapidly outgrew the volume of business which it could do on its rather limited capital. Its principal trading was in the Preferred and Common stock of the Julian Petroleum Corporation and it encouraged, by every possible manner, the purchase on the part of the public of the so-called Julian stocks. During that entire time the stock market trading continued hectic, with violent fluctuations, rapidly rising markets, and sudden declines (affecting the Julian stocks.)

As the result of our audits and investigations important information was from time to time imparted to the officers of the bank and to Mr. S. C. Lewis. Our original audits were followed by subsequent investigations and audits. The financial status and condition of the brokerage house needed constant attention in order to give the information to the bank while the bank was proceeding with its plans for the refinancing of the proposed Julian Petroleum Corporation merger.

During the processes of our auditing and investigating we learned that there were rumors on the street relative to the possibility that stock of the Julian Petroleum Corporation had been is- [7] sued in excess of the amount permitted to be issued by the State Corporation Department and even to the extent that it might exceed the total authorized capitalization of the company. In line with our duty that information was imparted to the officers

of the bank with the recommendation that there was a possibility of a moral obligation on the part of the bank before definitely concluding any proposed underwriting of bonds and the junior financing that there should be definite assurance as to the amount of stock outstanding. That resulted in conferences between the officials of the bank and Mr. Lewis.

The capital stock records of the Julian Petroleum Corporation had been for several reasons moved out of the State of California and were being kept in New York City. Upon the insistence of the bank those records were, however, brought back to the State of California and the bank insisted that an audit of those capital stock records should be made by the auditor of their selection for the purpose of ascertaining how much stock was actually outstanding. The taxpayer was accordingly engaged to make that audit.

Some delay was experienced in returning the books to the State of California and after their return there were further delays due to the activity in the transfer office and the fact that the records had not been kept up currently and because of thousands of transactions not having been recorded. Those records were dealt out to the auditors piecemeal. During that entire period the bank was still kept informed as to the progress being made, the difficulties encountered, our various findings, et cetera.

[8] It so happened that during the course of the audits which were being made of A. C. Wagy &

Co., Inc. and of the capital stock records, that the State Corporation Department of the State of California desired some information and also desired to make their own investigations. An agreement was entered into, however, between S. C. Lewis and the State Corporation Department whereby and wherein any and all information secured by the taxpayer, resulting from his investigations and audits, was likewise to be made available to the proper representatives of the State Corporation Department. The writer accordingly was imparting information not only to Mr. Lewis and the officers of the bank but to the heads of the State Corporation Department.

In spite of the difficulties and overcoming terrific obstacles, and solely as a result of his own dominating insistence, together with the cooperation of the bank and the State Corporation Department, the audit of the capital stock records was completed and the taxpayer immediately upon the completion of that work exposed the substantial overissue of the Julian stocks, reporting that information promptly upon the completion to Mr. Lewis, the bank and the State Corporation Department and insisted that that information should be given to the Board of Governors of the Stock Exchange and to the public in general. Reference to the newspaper files at the time of the Julian crash confirm the fact that the taxpayer exposed the overissue. The entire matter was immediately laid before the District Attorney of the County of Los Angeles and

was shortly thereafter presented to the Grand Jury of the County of Los Angeles.

[9] By devious processes many of the most prominent representative citizens of the State of California had been brought into contact with the company, with its officers, with its stock, with its market operations, with its loans, et cetera, et cetera. It has been said that the Julian Petroleum Corporation fiasco was the biggest thing of its kind ever perpetrated in the financial history of the world.

The taxpayer endeavored to aid and assist the District Attorney's office and the Grand Jury to contemplate the various ramifications which had been discovered by him as the result of his investigations and audits. For reasons which were not at that time known, the taxpayer with hundreds of other prominent citizens was indicted by the Grand Jury. There were investigations by Federal authorities, and by the Bureau of Internal Revenue.

The taxpayer was indicted, along with others, on two conspiracy charges: First, conspiracy to issue Julian Petroleum Corporation stock in excess of that permitted by the State Corporation Department, and, secondly, conspiracy to defraud through the sale of such overissued stock. A trial was held and there was a unanimous vote of acquittal for all of the defendants. In connection with the original indictments or in connection with the Julian crash no one has as yet been convicted except that one of the defendants, E. H. Rosenberg, and the District Attorney, Asa Keyes and his Chief Deputy, Harold L. (Buddy) Davis were subsequently convicted on

charges of bribery in connection with the Julian mess. During the course of the trial of the taxpayer and his co-defendants special investigators, [10] assigned by the Commissioner of Internal Revenue or by his representatives, listened to the entire proceedings and they are familiar with the evidence submitted, the arguments of counsel, et cetera.

Needless to say, there was not one bit of evidence against this taxpayer. All of the evidence introduced plainly indicated that he had exposed the overissue and that he had been constantly revealing instead of concealing the irregularities in connection with the stock issue and that every action on his part was exactly contrary to what would be expected of one who was engaged in a conspiracy to overissue stock or to defraud the public. He aided, through many of the investigations, the representatives of the Commissioner of Internal Revenue and assisted the receivers who were appointed for A. C. Wagy & Co., Inc. and the Julian Petroleum Corporation. At no time was there hardly a single individual who could understand why the taxpayer, after exposing the fraud, had been indicted. Subsequent developments, however, resulting in the conviction of the District Attorney and his Chief Deputy might be deemed to throw some light on that indictment.

Even an innocent man who has become enmeshed in such a fiasco must retain able counsel. Accordingly the taxpayer entered into a contract with the firm of Scarborough & Bowen for a fee of \$20,-

000.00, to advise with him and to defend him in connection with the matters previously referred to herein.

It must be clear that the taxpayer's contact with the Julian Petroleum Corporation and A. C. Wagy & Co., Inc., was solely and only in his capacity as an auditor and investigator, principally [11] for outside interests. The extent of the work done resulted in an increase in his gross income for the years 1926 and 1927. His contact was accordingly of a purely business nature. His indictment was occasioned because of that business contact. The legal expense involved must accordingly be deemed to be a necessary business expense and, as such, is contended to be properly deductible from the gross income.

The taxpayer, who is licensed to practice before the United States Board of Tax Appeals, is and has been for years familiar with the various Revenue Acts, the Regulations promulgated by the Commissioner of Internal Revenue, and is familiar with the decisions rendered by the United States Board of Tax Appeals covering various matters and, incidentally, relative to their decisions covering the payment of legal expenses in connection with any criminal indictment. There is no parallel in any case decided by the Board to the case now presented by the petitioner.

It has been stated that the books of the taxpayer have been kept on an accrual basis. There was deducted, however, during the year 1927 only such portion of the legal expense as had actually been

paid, due to the fact that at that time negotiations were pending whereby at least a portion of the legal expense would be paid by the bank which had engaged his services and the taxpayer though the only fair thing to do at that time was to deduct only such amounts as were paid during the various calendar years until such negotiations had been definitely settled and anticipated that when such negotiations were concluded an amended return could be prepared and filed.

[12] Because of the conditions previously explained the two corporations, A. C. Wagy & Co., Inc., and the Julian Petroleum Corporation, went into the hands of receivers. There was a period of negotiation and litigation and the best brains of the state devoted considerable time considering plans for salvaging as much as possible for the creditors and stockholders. For a time it was believed that bankruptcy and liquidation was the only solution. That, however, would have left the stockholders with no opportunity to recover anything, or only a very small and insignificant part of their respective investments. There was no question in anyone's mind but what everyone would have to take a substantial loss, with the exception of the secured creditors.

Most accountants, for income tax purposes, report on a cash basis. This taxpayer reports on an accrual basis. There is included in with the gross income all of the fees charged. At the time when the return was prepared the taxpayer and everyone else believed those debts to be uncollectible. The

law and the regulations permitted a man in his discretion and within reason to write off his uncollectible debts. The regulations likewise provide, however, that should a bad debt, once written off, be subsequently collected in whole or in part, that such amounts should be returned as income when and as collected. The taxpayer has not yet received any stock in settlement of his claim but has made a partial collection in cash of such portion of the fees as were chargeable against the receivers who retained him to complete his report on the status of the stock outstanding.

[13] To tax the gross income in 1927 at high surtax rates, although it is admitted that a substantial part of the bad debts written off but included in the gross fees will be uncollectible at least to a very substantial degree, is not equitable and is not fair. If the taxpayer was to-day to receive the stock contemplated to be issued to creditors that stock would only be worth approximately 1/20th of the amount of the debt. To permit the taxpayer only to deduct the 19/20ths loss during a subsequent year in lower brackets of surtax rates would not be fair and equitable. When the engagement was originally contracted for there was no contemplation of receiving practically worthless stock in consideration therefor.

This statement of facts may seem rather lengthy but it is in reality only a very rough outline. Obviously the taxpayer could elaborate considerably in this statement of facts. Only sufficient has been placed before you to justify the taxpayer's conten-

tion that the legal expense and the uncollectible fees are proper deductions. It is confidently expected that when the Commissioner's office is fully aware of all of the facts and circumstances in connection with those two disallowed items that they will be allowed and that the return as filed will be approved.

PROPOSITIONS OF LAW

6. The taxpayer in support of his appeal relies upon the following propositions of law:

Section 214 of the Revenue Act permits individuals to deduct as business expenses, under Section 214 (a)¹ all of the "Ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

[14] The expenses deducted for legal fees are deemed to be a proper legal expense of the taxpayer and that such expense was a necessary expense incident to his business.

Section 214 (a)⁷ provides

"In computing net income there shall be allowed as deductions debts ascertained to be worthless and charged off within the taxable year and when stated that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part."

It is contended that the debts deducted by the taxpayer were ascertained to be worthless in 1927 and were charged off within the taxable year, and especially is that point pertinent because the deduction

serves to reduce the gross income which includes those uncollectible fees during that same year. There is no one to deny the fact that the debt was at least partially worthless and, even though it is construed that stock may be issued in lieu of the debt, the fact that the stock, when issued, has a value so negligible as to almost make it worthless justifies the deduction in 1927. The fact that receivers were appointed for both companies is an indication of the worthlessness of the debt at the time.

The Regulations state "Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt".

In connection with worthless securities the Regulations state that if the taxpayer is able to demonstrate to the satisfaction of the Commissioner that there is an uncollectible part of [15] a debt evidenced by bonds or other similar obligations due to the financial condition of the debtor, he may make such deduction.

WHEREFORE, the taxpayer respectfully prays that this Board may hear and determine its appeal.

WM. C. KOTTEMANN

814-820 Western Pacific Bldg.,
1031 South Broadway,
Los Angeles, California.

[16]

State of California

County of Los Angeles—ss

WM. C. KOTTEMANN, being duly sworn, says he is the taxpayer named in the foregoing petition

Appeals within sixty days (not counting Sunday as the sixtieth day) from the date of the mailing of this letter for a redetermination of your tax liability.

HOWEVER, IF YOU DO NOT DESIRE TO PETITION, you are requested to execute the enclosed Form 866 and forward both original and duplicate to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing of this agreement form will expedite the closing of your return by permitting an early assessment of any deficiencies and preventing the accumulation of interest charges, since the interest period terminates thirty days after filing the agreement form, or on the date assessment is made, whichever is earlier; WHEREAS IF NO AGREEMENT IS FILED, interest will accumulate to the date of assessment of the deficiencies.

Respectfully,

ROB'T H. LUCAS

Commissioner.

By: DAVID BURNET

Deputy Commissioner.

Enclosures

Statement

Form 866

Form 882

Form 7928—Rev. Dec., 1928

[18] STATEMENT

IT:AR:B-10

HRK—60D

August 7, 1929

In re: Mr. William Kottemann,
1031 South Broadway
Los Angeles, California

Tax Liability

Year	Corrected Tax Liability	Tax Previously Assessed	Deficiency
1926	\$4,299.63	\$4,299.63	None
1927	5,684.29	2,805.66	\$2,878.63
Totals	<u>\$9,983.92</u>	<u>\$7,105.29</u>	<u>\$2,878.63</u>

The report of the Internal Revenue Agent in Charge at San Francisco, California, for the years 1926 and 1927, has been reviewed and approved by this office with the following exception:

1927

Bad debts of \$12,305.71 and \$1,015.65 claimed on your return as being uncollectible from the Julian Petroleum Corporation and the A. C. Wagy and Company, Incorporated, respectively, were allowed by the agent for 50% or \$6,660.68 for the reason that it is doubtful whether more than 50% of the debts will ever be collected. This office, however, holds that no part of the bad debts are deductible in 1927 for the reason that they have not been ascertained to be worthless since both companies, now in receivership, propose to pay the unsecured claims

in stock. In this event the stock that will be received takes the place of the indebtedness and any loss sustained when the stock is disposed of is deductible.

1926

Your return for the year 1926 disclosing a net income of \$46,894.70 and a tax liability of \$4,299.63 has been accepted by this office as originally filed.

1927

Net income disclosed by return		\$38,064.58
Add:		
1. Legal fees	\$ 3,500.00	
2. Bad debts	13,321.36	16,821.36
	<hr/>	<hr/>
Corrected net income		\$54,885.94
[19]		
Mr. William Kottemann.		Statement
Brought forward		\$54,885.94
Less:		
Personal exemption	\$3,500.00	
Dividends	1,981.51	5,481.51
	<hr/>	<hr/>
Income subject to normal tax		\$49,404.43
Normal tax at 1½% on \$4,000.00		\$ 60.00
Normal tax at 3% on \$4,000.00		120.00
Normal tax at 5% on \$41,404.43		2,070.22
Surtax on \$54,885.94		3,644.03
		<hr/>
Total		\$ 5,894.25

Less:

Earned income credit	\$ 206.25	
Tax paid at the source	3.71	209.96
	<hr/>	<hr/>
Corrected tax liability		\$ 5,684.29
Tax previously assessed		2,805.66
		<hr/>
Deficiency in tax		\$ 2,878.63

Explanation of Changes

1. Legal fees paid to Scarborough and Bowen for defending you against an indictment are disallowed since they are a personal expense. See appeal of Estate of George Backer published in United States Board of Tax Appeals Volume 1, Pages 214.

2. This item has been fully explained above.

Payment should not be made until a bill is received from the Collector of Internal Revenue for your district, and remittance should then be made to him.

[20] [Title of Court and Cause.]

[Endorsed]: Filed December 2 1929

ANSWER

Comes now the Commissioner of Internal Revenue, by his attorney, C. M. Charest, General Counsel, Bureau of Internal Revenue, and for answer to the petition filed in the above-entitled appeal, admits and denies as follows:

1. Admits the allegations in paragraph 1 of the petition.

2. Admits the allegations in paragraph 2 of the petition.

3. Admits the allegations in paragraph 3 of the petition

4. Denies the allegations of error in sub-paragraphs (a) to (g), inclusive, of paragraph 4 of the petition.

5. Denies the allegations in paragraph 5 of the petition.

Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified or denied.

WHEREFORE, it is prayed that petitioner's appeal be denied.

(Signed) C. M. CHAREST

General Counsel,

Bureau of Internal Revenue.

OF COUNSEL: A. H. MURRAY, Special Attorney, Bureau of Internal Revenue.

AHM/SEP/vgs 11/2/29

[21] [Title of Court and Cause.]

[Endorsed]: Filed Oct 5, 1933

FIRST AMENDMENT TO PETITION

Comes now the Petitioner and having first obtained leave of the Board files this as his First Amendment to Petition, appealing from the deter-

mination of the Respondent set forth in his deficiency letter dated August 7, 1929, symbols IT:AR:B-10 HRK-60D. Petitioner prays that his original petition be amended by the insertion of the following paragraphs:

I

That a new assignment of error under paragraph IV of the original petition be inserted, designated as (h) as follows:

(h) Respondent erred in failing to recognize the community property laws of the State of California, which gave a vested interest to Petitioner's wife in community income acquired on or after July 29, 1927, thereby overstating the net taxable income of this Petitioner.

II

That two new paragraphs be inserted in the statement of facts in the original petition under paragraph V, designated as 5 (b) and 5 (c), as follows:

5 (b) During the year here under appeal Petitioner earned as a result of his professional services the sum of \$21,430.80 subsequent to July 29, 1927, the effective date of the Civil Code Amendment by the [22] Legislature for the State of California which declared a vested interest in Petitioner's wife in community earnings. Notwithstanding the fact that Petitioner and his wife filed separate returns, the Respondent in determining Petitioner's net taxable income added the entire amount of income so

earned after July 29, 1927 as taxable income to the Petitioner, thereby overstating Petitioner's taxable income by at least \$10,715.40.

5 (c) Petitioner alleges that he has overpaid his taxes for the year 1927 and prays that the Board hear and determine his petition as amended and render judgment in accordance with the foregoing, and order the taxes so overpaid by Petitioner be refunded. Petitioner prays for such other and further relief as may be deemed meet and proper in the premises.

THOMAS R. DEMPSEY (Sgd)

A. CALDER MACKAY (Sgd)

ARTHUR McGREGOR (Sgd)

Attorneys for Petitioner

1104 Pacific Mutual Building

Los Angeles, California.

[23]

State of California

County of Los Angeles—ss.

WM. C. KOTTEMANN, being first duly sworn, deposes and says: That he is the Petitioner above named; that he has read the foregoing First Amendment to his Petition and knows the contents thereof and that the same is true of his own knowledge except the matters which are therein stated to be upon information and belief and that as to those matters he believes it to be true.

WM. C. KOTTEMANN (Sgd)

Subscribed and sworn to before me this 5th day of
October, 1933.

(s) CARTER DALY

Notary Public in and for said
County and State.

Authorized to administer
oaths under the Revenue Act
of 1926

Respondent entered a general denial to the amend-
ment to the petition at the hearing on Oct. 5, 1933.

[24] United States Board of Tax Appeals

WM. C. KOTTEMANN, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

BERTHA M. KOTTEMANN, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket Nos. 45929, 61238, 61239, 61240, 61241.

A. Calder Mackay, Esq., and Arthur McGregor, Esq., for the petitioners.

T. M. Mather, Esq., for the respondent.

MEMORANDUM OPINION

VAN FOSSAN: Petitioners bring these proceedings for the redetermination of deficiencies in income taxes for the calendar years 1927, 1928 and 1929 as follows:

Docket No.	Petitioner	Year	Deficiency
45929	Wm. C. Kottemann	1927	\$2,878.63
61238	“ “	1928	41.36
61239	“ “	1929	325.49
61240	Bertha M. Kottemann	1928	40.64
61241	“ “	1929	158.48

In this opinion the term “petitioner” will be used to refer to Wm. C. Kottemann individually, references to Bertha M. Kottemann being made in other terms.

[25] The cases involve the following propositions:

(1) Is the petitioner entitled to a deduction for

the year 1927 of bad debts written off as uncollectible in the amounts of \$12,305.71 and \$1,015.65, which were due from the Julian Petroleum Corporation and A. C. Wagy & Company, Inc., respectively, for services rendered during the year 1927?

(2) Is the petitioner entitled to take as a deduction from income the amount of \$20,000—legal expense incurred during the year 1927, or any portion thereof in 1927 or any other year here involved?

(3) What is the amount of community income earned by petitioner during the year 1927; and what portion thereof should be allocated to each spouse?

(4) Were the petitioners entitled to deduct from income as business expense, legal fees paid in the year 1929 in the amount of \$1,336.06 in equal proportions on their respective separate returns for said year?

Petitioner resides with his wife, Bertha M. Kottemann, at Los Angeles, California, and is engaged in the practice of public accounting, being licensed to practice as a certified public accountant in the States of New York and California. Petitioner and his wife, during all of the years here involved, were living together and each spouse filed separate returns of income for each of the years 1927, 1928 and 1929 with the collector of Internal Revenue at Los Angeles, California. Subject to an exception hereinafter noted petitioner has kept his books of account and records on the accrual basis for all years, and the returns of both petitioner and his wife were filed on that basis.

[26] Petitioner was employed during the year 1927 to make an audit of the brokerage firm of A. C. Wagy & Company, Inc., a concern which was controlled by officers of the Julian Petroleum Corporation. On February 10, 1927 petitioner also obtained employment to make a complete audit of the capital stock records, stock books, stock transfer books, etc., of the Julian Petroleum Corporation. The income due petitioner as a result of this employment was placed on his books currently as it accrued and statements of the amounts due and owing from such sources were rendered to these two corporations accordingly. The audit of the Julian Petroleum Corporation was commenced on February 14, 1927 and was terminated May 16, 1927.

The audit made by petitioner disclosed that the stock of the Julian Petroleum Corporation had been over issued approximately six times that authorized by the State Corporation Commissioner of California. The over-issue was reported by petitioner to the District Attorney of Los Angeles County, the Board of Governors of the Los Angeles Stock Exchange, the State Corporation Department, the banks and the newspapers. Both the Julian Petroleum Corporation and the A. C. Wagy & Company, Inc. went into bankruptcy shortly after the over-issue was exposed in May, 1927.

At the close of the year 1927 there was due the petitioner from the Julian Petroleum Corporation \$12,305.71 and from the A. C. Wagy & Company, Inc. \$1,015.65 which had not been paid but had been accrued and which was reported as income on peti-

tioner's income tax return. [27] From May, 1927, to the end of the year petitioner made numerous attempts to collect these balances. By reason of his access to the books and records petitioner had personal knowledge of the financial condition of the two companies. Before the close of the year 1927 petitioner knew that numerous suits for attachment had been brought against both corporations; that receivers had been appointed and that the financial condition of both companies was such that they were hopelessly insolvent. Petitioner knew that the Julian Petroleum Corporation had substantial bank overdrafts and that the current assets amounted to only approximately 21 per cent of the unsecured liabilities. On May 20, 1927 there were current unsecured liabilities of \$3,663,752.42 while the total current assets amounted to \$1,177,748.07, making a deficiency of working capital of \$2,486,004.35. In addition thereto there were secured liabilities totaling \$5,737,688.18. The receivers reported that the current liabilities of the Julian Petroleum Corporation greatly exceeded the current assets; a one-half monthly payroll of \$110,000 was due and its bank overdrafts exceeded \$130,000; it had no banking or commercial credit.

Petitioner's efforts to collect the amounts due from these two corporations were of no avail. Before the close of the calendar year 1927 petitioner reasonably ascertained that the \$12,305.71 due from the Julian Petroleum Corporation and the \$1,015.65 from the A. C. Wagye & Company, Inc. for services so rendered were worthless and therefore wrote them

off his books as bad debts and took same as a deduction on his income tax return for that year.

[28] Petitioner filed claims with the receivers of both of these corporations, which were accepted and approved. After protracted litigation plans were formulated wherein each of the respective classes of creditors of the Julian Petroleum Corporation were to receive certain shares of stock of a reorganized corporation and certain of its bonds. The Judge of the Federal District Court in 1929 approved the plan and during the year 1930 petitioner received \$6,900 par value debenture bonds of the Sunset Pacific Oil Company and a debenture trust certificate of the face value of \$58.31 and 327 shares of Series "B" stock which were issued to him to cover the unpaid balance on his claim against the Julian Petroleum Corporation. The A. C. Wagy & Company, Inc. has never distributed anything to its creditors to date nor, according to the record, is there any likelihood of any distribution.

The stock and securities of the Sunset Pacific Oil Company had little or no value.

During the year 1929 petitioner received \$3,110.25 from the Julian Petroleum Corporation for services rendered after the date of the receivership which was a part of the \$12,305.71 charged off as a bad debt in 1927. This sum was reported as income in petitioner's 1929 income tax return.

We are satisfied that petitioner acted reasonably in charging off the debts due from the two companies in 1927. He was in a peculiarly advantage-

ous position to know the facts and the facts would have lead any reasonable man to do as he did. We approve the deduction of the two items for 1927.

[29] The second issue involves, in part, the same background. Petitioner, together with a large number of prominent people of the State of California (approximately 100) was indicted. Two charges were brought, one of conspiracy to violate the State Corporate Securities Act through the over-issuance of Julian Petroleum Corporation stock and the other to defraud the public through the sale of such stock. The indictment was issued against petitioner on June 24, 1927, and in order to defend himself he was compelled to employ attorneys to represent him. Under date of August 18, 1927, he entered into an agreement with the law firm of Scarborough & Bowen of Los Angeles, wherein he agreed to pay for their services the sum of \$20,000. Petitioner paid under this contract \$3,500 during the year 1927, \$3,500 in the year 1928, and \$6,500 in the year 1929. Petitioner took on his 1927 return a deduction from income of \$3,500, on his 1928 return \$3,500 and on his 1929 return the \$6,500 paid during that year, as well as the accrual of the \$6,500 still due under the contract. Petitioner was tried and acquitted as were all of the other defendants who were tried at that time.

We are convinced that respondent was in error in disallowing the deduction of the sums paid to the attorneys who defended petitioner against the indictment. Had petitioner not accepted the employment by Julian Petroleum Corporation the charges would not have been made nor the indictment found. As

events proved, petitioner was guilty of no wrongdoing. The case seems to come clearly within the decisions in *Kornhauser v. United States*, 276 U. S. 145; *Citron-Byer Co.*, 21 B. T. A. 308; *H. M. Howard*, 22 B. T. A. 375; *Matson Navigation Co.*, 24 B. T. A. 14.

[30] Although petitioner reported on the accrual basis he did not claim the entire sum agreed to be paid in 1927 by the terms of the contract, all of the \$20,000 being due in that year, because he hoped to have part of the expense assumed by others and undertook negotiations to this end. That petitioner still retained hope that part of the expense would be so assumed in 1928 is evidenced by the fact that he did not accrue the entire sum for 1927. He deducted for 1927 and 1928 only the sums actually paid. In 1929 he deducted the remaining balance including \$6,500 paid and a like amount accrued against future payment. In this last deduction we believe he erred. Having departed from the accrual basis as to this item of \$20,000 and having employed the cash basis as to it for two years, he could not, at his election, go to the accrual basis in 1929. Such action would not accurately reflect income for that year as the indebtedness was not incurred in that year. The deduction of \$6,500 accrued on petitioner's books but not paid is disallowed.

During the year 1927 petitioner earned from his accounting profession gross fees amounting to \$121,612.66. This amount included accruals indicated above of \$12,305.71 from the Julian Petroleum Cor-

poration and \$1,015.65 due from the A. C. Wagy & Company, Inc., which were written off as bad debts during the year. This gross income was reported on petitioner's return under Schedule A. The deductions incident to petitioner's business or profession are shown on Schedule A of his return, amounting to \$87,000.09. Included in these deductions [31] are the sums of \$3,500, legal fees paid to Scarborough & Bowen, bad debts of \$12,305.71 referred to above due from Julian Petroleum Corporation, and the sum of \$1,015.65 due from A. C. Wagy & Company, Inc. These figures and other figures consequent on the application of the conclusions announced herein will be given effect in making recomputations.

Petitioner and his wife divided the community income equally between them and each reported one-half of such community income on their separate returns for the years 1928 and 1929. For the year 1927 all of the community earnings were reported by the petitioner. In July, 1927 the Civil Code of California was amended giving the wife a vested interest in community earnings.

It was stipulated that a reasonable allocation of the community earnings allocable to petitioner's wife during the year 1927 is one-half of 5/12ths of the net income that the Board finds petitioner earned from professional services after allowing a reasonable return on investment used in his business. The balance should be allocated to the petitioner. The investment used in petitioner business is \$12,000 and a reasonable return on this investment is 10 per cent.

In determining petitioner's income for the calendar year 1929, respondent disallowed \$14,336.06, which sum included the balance due from the petitioner on the Scarborough & Bowen contract referred to above for legal services, in the amount of \$13,000 in connection with the indictment, plus \$1,336.06 covering legal fees paid to other attorneys.

[32] We have already indicated our holding as to the deductions for fees paid in connection with the indictment. The record establishes that the remaining item of \$1,336.06 was paid in 1929 for services rendered in effecting collections, drawing agreements and such matters growing out of the business. It should be allowed.

Decisions will be entered under Rule 50.

[Seal]

Entered Mar 6 1934

[33] United States Board of Tax Appeals

Docket No. 45929

WM. C. KOTTEMANN,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to memorandum opinion of the Board entered March 6, 1934, the respondent in the above entitled proceeding filed a proposed recomputation

of the tax on April 3, 1934, and the case having been called for settlement on April 25, 1934, at which time no objection was offered to the proposed settlement, it is

ORDERED and DECIDED that there is an over-payment for the year 1927 in the amount of \$986.21.

(Signed) ERNEST H. VAN FOSSAN
Member.

[Seal]

Entered Apr 27 1934

[34] [Title of Court and Cause.]

[Endorsed] : Filed Jul 23 1934

PETITION FOR REVIEW OF DECISION OF
THE UNITED STATES BOARD OF TAX
APPEALS.

To the Honorable Judges of the United States Circuit Court of Appeals for the Ninth Circuit :

Wm. C. Kottemann, in support of this, his petition, filed in pursuance of the provisions of Section 1001 of the Act of Congress approved February 26, 1926, entitled "The Revenue Act of 1926", as amended by Section 603 of the Act of Congress approved May 29, 1928, entitled "The Revenue Act of 1928", and as further amended by Section 1101 of the Act of Congress approved June 6, 1932, entitled "The Revenue Act of 1932", for the review of the decision of the United States Board of Tax Appeals promulgated March 6, 1934, a final order of deter-

mination having been entered April 27, 1934, respectfully shows to this Honorable Court as follows:

I

STATEMENT OF THE NATURE OF THE CONTROVERSY.

BRIEF STATEMENT OF FACTS.

There is but one question presented in this appeal, namely, is the Petitioner entitled to take as a deduction from gross income for the year 1927 the entire amount of legal expenses incurred during that year in [35] the sum of \$20,000.00, or is he limited to the amount actually paid during said year of \$3,500.00.

The facts relative to this issue are as follows:

Petitioner resides with his wife, Bertha M. Kottemann, at Los Angeles, California, and is engaged in the practice of public accounting, being licensed to practice as a Certified Public Accountant in the States of New York and California. Petitioner and his wife were living together during the year 1927 and each filed separate returns of income for the year 1927 with the Collector of Internal Revenue at Los Angeles, California. Petitioner for all years has consistently kept his books of account and records on the accrual basis and the returns of Petitioner and his wife were filed on that basis.

Petitioner was employed during the year 1927 to make an audit of the brokerage firm of A. C. Waggy & Company, Inc., a corporation, which was controlled by officers of the Julian Petroleum Corporation. Be-

cause of the demand for an independent audit of the stock records of the Julian Petroleum Corporation made by the First National Bank and the Pacific Southwest Trust & Savings Bank of Los Angeles, Petitioner, on February 10, 1927, was employed to make a complete audit of the capital stock records, stock books, stock transfer books, etc. of said corporation. The income due Petitioner as a result of this employment was placed on his books currently as it accrued and statements of the amounts due and owing from such sources were rendered to these two corporations accordingly. The audit of the Julian Petroleum Corporation was commenced on February 14, 1927, and was terminated May 16, 1927.

The audit made by Petitioner disclosed that the stock of the Julian Petroleum Corporation had been overissued approximately six times the [36] amount authorized by the State Corporation Commissioner of California. The overissue was reported by Petitioner to the District Attorney of Los Angeles, California, the Board of Governors of the Los Angeles Stock Exchange, the State Corporation Department, the banks and the newspapers. Both the Julian Petroleum Corporation and the A. C. Wagy & Company, Inc. went into bankruptcy shortly after the overissue was exposed in May of 1927.

As a result of the disclosure of the large overissue of stock of the Julian Petroleum Corporation, in the spring of 1927 various and sundry investigations were instituted by the District Attorney's office, Grand Jury and other bodies, which resulted in the indictment of a large number (approximately

100) of prominent people of the State of California, including this Petitioner. Two charges were brought, one of conspiracy to violate the State Corporate Securities Act through the overissue of Julian Petroleum Corporation stock, and the other to defraud the public through the sale of such stock. The indictment was issued against this Petitioner on June 24, 1927, and in order to defend himself he employed the law firm of Scarborough and Bowen of Los Angeles, California. Under date of August 18, 1927, he entered into a written agreement wherein he agreed to pay these lawyers for their services the sum of \$20,000.00.

The entire sum of \$20,000.00, which Petitioner agreed to pay for legal services under the written contract, was all due and payable in 1927. However, Petitioner accrued only \$3,500.00, which he paid during said year, and which he took as a deduction on his income tax return. During the year 1928 he paid an additional \$3,500.00, which he accrued on his books and took as a deduction on his income tax return filed for that year. During the year 1929 an additional sum of \$6,500.00 was paid, which sum Petitioner accrued on his books, together with the balance (\$6,500.00) that was still [37] due and owing and took as a deduction on his return for said year 1929 the sum of \$13,000.00.

Petitioner was tried and acquitted. Subsequently, District Attorney Asa Keyes, together with his associates, who caused the indictment of this Petitioner, and others, were indicted in connection with this fiasco and charged with accepting bribes. Mr.

Asa Keyes was convicted and served a term in San Quentin Prison. Although Petitioner kept his books and filed his returns on the accrual basis, he accrued only \$3,500.00 of the \$20,000.00 legal fee on his books in 1927 for the reason that during the latter part of said year he was negotiating with officers and attorneys of the First National Bank and the Pacific Southwest Trust & Savings Bank of Los Angeles with the hope that said banks would stand part of this legal expense. There were some temporary assurances that something would be allowed or paid by them; therefore, Petitioner was reluctant to take the entire deduction on his 1927 return, knowing that he could subsequently file amended returns to adjust this item. The banks declined to pay any portion of this legal expense.

Had Petitioner not accepted the employment to make an audit of the Julian Petroleum Corporation stock records, the charges would not have been made, nor the indictment found. A majority of Petitioner's income earned during said year and reported on his 1927 income tax return was fees earned and accrued on his books and records in connection with his professional duties as a Certified Public Accountant in making audits of the Julian Petroleum Corporation and the A. C. Wagy & Company, Inc. books.

The United States Board of Tax Appeals held that Petitioner was entitled to deduct from his gross income but \$3,500.00 (the amount actually paid during 1927) of the \$20,000.00 legal expenses incurred during the year 1927.

[38]

II

STATEMENT OF PROCEEDINGS
HERETOFORE HELD.

The Commissioner of Internal Revenue, the Respondent herein, on August 7, 1929, mailed to Petitioner what is termed a deficiency letter, wherein the Commissioner proposed additional income taxes for the year 1927 in the sum of \$2,878.63. Within the sixty day period, as provided by law, the Petitioner filed his appeal to the United States Board of Tax Appeals, wherein he alleged among other things that the Respondent erred in denying to Petitioner the right to treat as a proper business expense and as a deduction from his gross income the \$20,000.00 agreed to be paid to the law firm indicated above, or any part thereof. As indicated above, the Board determined that Petitioner was entitled to take as a deduction in 1927 the sum of \$3,500.00 only.

The Board's decision was promulgated on April 3, 1934, and its final order of determination was entered on April 27, 1934.

III

DESIGNATION OF COURT OF REVIEW.

Petitioner, being aggrieved by the said Opinion, Order and Decision, and being a resident of the City of Los Angeles, State of California, desires a review thereof, in accordance with the provisions of the Revenue Act of 1926, as amended by the

Revenue Act of 1928 and as further amended by the Revenue Act of 1932, by the United States Circuit Court of Appeals for the Ninth Circuit, within which circuit is located the office of the Collector of Internal Revenue to which the said Petitioner made his Federal income tax return.

[39]

IV

ASSIGNMENTS OF ERROR.

Petitioner, as a basis of review, makes the following assignments of error:

1. The Board of Tax Appeals erred in failing to allow as a deduction from Petitioner's gross income for the year 1927 the entire sum of \$20,000.00 legal fees incurred and which were due and payable during said year.

2. The Board of Tax Appeals erred in holding that Petitioner's items of income were all accruable but part of his items of expense was not accruable in computing Petitioner's taxable income.

3. If the Board of Tax Appeals is correct in its determination that only \$3,500.00 of the \$20,000.00 legal expenses incurred in 1927 was properly accruable, then the Board erred in failing to hold that Petitioner's other items of expense and all of his items of income should have been placed on the cash receipts and disbursements basis.

4. The Board of Tax Appeals erred in failing to determine that Petitioner was entitled to a refund of at least \$2,319.79 in lieu of \$878.06 as determined by said Board.

WHEREFORE, Petitioner prays that this Honorable Court may review the said findings, opinion, decision and order of the United States Board of Tax Appeals and reverse and set aside the same; and that this Honorable Court direct the entry of a decision by said Board in favor of Petitioner, determining that the entire legal expense of \$20,000.00 incurred during the year 1927 was a proper deduction from income in determining the tax liability of this Petitioner. Petitioner further prays that this Honorable Court direct the Board to determine the amount of refund to be [40] \$2,319.79 with interest, in lieu of the \$878.06 determined by said Board and direct the Board to reverse its decision accordingly.

Petitioner prays for such other and further relief as may be meet and proper in the premises.

THOMAS R. DEMPSEY (Sgd)

A. CALDER MACKAY (Sgd)

ARTHUR MCGREGOR (Sgd)

Counsel for Petitioner

1104 Pacific Mutual Building

Los Angeles, California.

[41]

State of California

County of Los Angeles—ss.

A. Calder Mackay, being duly sworn, says that he is one of the attorneys for the Petitioner above named and that as such is duly authorized to verify

the attached Petition for Review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision of the Board rendered herein; that he has read the said Petition and is familiar with the statements therein contained, and that the facts set forth therein are true to the best of his knowledge and belief and that the said Petition is filed in good faith.

A. CALDER MACKAY.

Subscribed and sworn to before me this 21st day of July, 1934.

[Seal]

LAURA TEETER (Sgd)
Notary Public in and for said
County and State.

[42] [Title of Court and Cause.]

[Endorsed]: Filed Jul 23 1934

NOTICE

To Robert H. Jackson, Esq.,
Bureau of Internal Revenue,
Washington, D. C.,
Attorney for the Respondent.

Sir: Please take notice that on the 23rd day of July, 1934, the undersigned presented to this Board and filed with the Clerk thereof the Petition of Wm. C. Kottemann, a copy of which is annexed hereto, for review by the United States Circuit Court of Appeals for the Ninth Circuit, of the final

order and decision of the Board in the above entitled proceeding entered upon the records of said Board on April 27, 1934.

Dated at Washington, D. C., July 23rd, 1934.

THOMAS R. DEMPSEY (Sgd)

A. CALDER MACKAY (Sgd)

ARTHUR McGREGOR (Sgd)

Attorneys for Petitioner

1104 Pacific Mutual Building

Los Angeles, California.

Service of a copy of the petition for review, together with notice of filing, is hereby acknowledged this 23rd day of July, 1934.

ROBERT H. JACKSON

Assistant General Counsel for the

Bureau of Internal Revenue.

[43] [Title of Court and Cause.]

[Endorsed]: Filed Nov 19 1934

PRAECIPE FOR TRANSCRIPT OF RECORD.

To the Clerk of the United States Board of Tax Appeals:

You will please prepare and certify to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit within the time provided by the rules of that court in this respect, as extended, a transcript of record for review herein consisting of the following documents:

1. The docket entries of the proceedings before the United States Board of Tax Appeals.

2. All pleadings before the United States Board of Tax Appeals in this cause.

3. Memorandum Opinion and Decision of the Board.

4. Petition for Review and notice of filing, with acknowledgment of service.

5. This Praecipe.

THOMAS R. DEMPSEY (Sgd)

A. CALDER MACKAY (Sgd)

ARTHUR McGREGOR (Sgd)

Los Angeles, California, November 16th, 1934.

Service of a copy of the within Praecipe is hereby admitted this 19th day of November, 1934.

ROBERT H. JACKSON

Attorney for Respondent.

[Title of Court and Cause.]

CERTIFICATE

I, B. D. Gamble, Clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 43, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 30th day of Nov., 1934.

[Seal]

B. D. GAMBLE
Clerk,
United States Board
of Tax Appeals.

[Endorsed]: Transcript of the Record. Filed December 28, 1934, Paul P. O'Brien, U. S. Circuit Court of Appeals for the Ninth Circuit.